

United States ⁹
Circuit Court of Appeals
For the Ninth Circuit

FIDELITY & DEPOSIT COMPANY OF MARYLAND,
a Corporation,

Plaintiff in Error,

vs.

JOHN P. DUKE, Supervisor of Banking of the
State of Washington, liquidating the KELSO
STATE BANK,

Defendant in Error.

Upon Writ of Error to the United States District Court for the
Western District of Washington, Southern Division.

HON. EDWARD E. CUSHMAN, *District Judge.*

Brief of Defendant in Error

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Vancouver, Washington.

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STATEMENT

For a number of years prior to the 17th day of March, 1921, the Kelso State Bank was engaged in a general banking business at Kelso, Washington. During this time F. L. Stewart was the cashier of the bank, owned a large share of the stock of the bank

and was the general manager and exercised control over the business affairs of the bank. On the 17th day of March, 1921, the banking department of the state of Washington took charge of the bank and it has since been in liquidation under the laws of Washington. In 1913 a bond was given to the bank by the cashier conditioned to reimburse the bank for all loss which the bank might sustain "by any dishonest act or acts" of the said Stewart in the performance of the duties of his office or employment. This bond was continued in force by annual renewals until April 30, 1920, when a new bond was given, the condition of the new bond reading "against the loss, not exceeding twenty-five thousand (\$25,000.00) dollars, of any money or other personal property (including money or other personal property for which the employer is responsible) through the fraud, dishonesty, forgery, theft, embezzlement or wrongful abstraction of F. L. Stewart, hereinafter called the employee, directly or in connivance with others."

This bond continued in force until the closing of the bank on the 17th of March, 1921. The record will disclose that the bank had been insolvent for a number of years prior to the 17th of March, 1921, and was insolvent when the items involved in this controversy were taken by Stewart. Stewart was familiar with the insolvent condition of the bank.

Under the name of the Kelso Farm Company Stewart borrowed from the bank \$5950.00. \$2200.00 of this loan was made on February 12, 1921, and

\$3750.00 on February 15, 1921. Stewart drew from the bank and used for his own purposes the sum of \$5000.00 on January 19, 1921, known in the record as the Fisk dummy note, and on September 10, 1920, at the solicitation of Stewart one Fritz Kruse gave a note for \$5000.00, which Stewart put in the bank and received the money; no consideration was received for the note, it was given to assist Stewart. All of the foregoing items were made after the last bond was given.

During the year 1920 the bank through Stewart discounted notes of the Northwest Transportation Company to the amount of \$5854.78, and during the same year the bank discounted notes given by Frank Shepard, Stewart receiving sums to the amount of \$3200.00, and during the year 1918 the bank discounted notes given by H. D. Phillips to Stewart amounting to at least the sum of \$3550.00. In addition to these items Stewart as administrator of the Richter estate transferred to the bank four warrants aggregating \$2000.00, which the liquidating officer was forced to return to the Richter estate.

The three items, namely, the Kelso Farm loan, the Kruse accommodation note, and the Fisk dummy note, was money taken directly by Stewart from the bank. The Richter warrant was money taken from the bank by Stewart upon an illegal transfer by Stewart of warrants belonging to an estate of which Stewart was administrator. The other items mentioned were instances where money was taken from

the bank by Stewart on notes in which he was personally and directly interested, and discounted to the bank by him.

The trial court, in effect, held that the money was fraudulently and illegally abstracted from the bank by Stewart at a time when he was the cashier and managing officer of the bank and that the taking of the money by Stewart created a liability under the bonds given by the plaintiff in error. All of these withdrawals of money from the bank by Stewart were made after the passage of the state banking law of Washington in 1917.

Section 3259 of Remington's Compiled Statutes of Washington prohibits any loans to officers or employees of the bank, directly or indirectly, unless a resolution authorizing the same and approved by a majority of the directors at a meeting in which no director, officer or employee to whom the loan is to be made is present, shall be entered in the corporate minutes, and further provides that any officer who shall borrow or shall knowingly permit any of its officers or employees to borrow any of its funds in an excessive amount or in violation of the provisions of this section shall be personally liable and shall also be guilty of a felony.

Under the laws of Washington (Sections 5072-5077 of Remington's Compiled Statutes of Washington) the county commissioners were required to designate certain banks which should become depositaries

of public funds and required banks so designated to furnish a bond to the county treasurer to cover any loss the county might sustain by reason of the failure of the bank. The plaintiff in error here had furnished a bond under the provisions of this law to the county treasurer of Cowlitz county indemnifying the treasurer against loss which might arise through the insolvency of the Kelso State Bank. At the time the bank failed the county had a large sum of money on deposit in the Kelso State Bank. The plaintiff in error paid to the county the sum of \$46,163.29 on account of its liability on the treasurer's bond, and took an assignment of the claim and subsequently presented its claim to the liquidating officer of the bank and has been receiving the dividends paid by the liquidating officer upon its claim.

ARGUMENT

SET OFF

Counsel first complain of the refusal of the trial court to allow the assigned claim of the plaintiff in error growing out of its liability to the county treasurer as an off-set against its liability on the bond of the cashier.

The present suit is an action for damages growing out of the dishonest and fraudulent acts of Stewart and is based on the cashier's bond to the bank. It is an action for damages and sounds in tort.

Where the question of off-sets has come up in connection with insolvency of banks the courts hold that the rights of the parties become fixed as of the time when the bank was taken charge of by the liquidating officer.

Section 266 of Remington's Compiled Statutes of Washington reads, in part, as follows:

"The defendant in a civil action upon a contract expressed or implied, may set off any demand of a like nature against the plaintiff in interest which existed and belonged to him at the time of the commencement of the suit."

In *Yardley vs. Philler*, 17 Sup. Ct. Rep. 835, the Supreme Court of the United States held that the right to a set-off against a receiver of a bank is to be governed by the state of things existing at the moment of insolvency and not by conditions thereafter

created, and the rule is that a debtor of an insolvent bank cannot set off against his debt a claim against it which was assigned to him after its insolvency.

State Bank vs. Spangler, 32 Pa. 474.

Nix vs. Ellis, 45 S. E. 404; 118 Ga. 345.

It is held in *Santleben vs. Frobes*, 43 S. W. 571, that promissory notes given by plaintiff to defendant cannot be set-off in a suit for the recovery of stock, or for judgment for its value, as a liquidated demand cannot be set off against a claim for unliquidated damages.

And in *Louisville-Nashville R. R. Co. vs. Empire State Chemical Co.*, 189 Fed. 174:

“In a statutory action by a railroad company for demurrage the court held that the defendant could not off-set a claim for damages for failure to promptly furnish cars, for the claims must not only be mutual but must be the same character of demand.”

The court will notice in this case that the language of our statute is similar to the distinguishing feature of the case just cited, namely, that demand must be of a like nature.

In 34 Cyc. 678, the rule is given:

“But defendant cannot recoup for matters not connected with the basis of plaintiff’s claim and which are founded upon an independent and distinct contract or transaction. And the mere

fact that by one transaction defendant came under obligation to enter into the other does not make them the same."

And on page 690 of 34 Cyc.:

"Defendant may claim in reconvention damages arising out of the same contract or transaction which affords the ground of suit, whether the agreement be embodied in one instrument or several; but not as a general rule for matters not connected with the subject of plaintiff's action."

And on page 696 of 34 Cyc.:

"Under a large majority of the statutes it has been uniformly held that unliquidated damages cannot be pleaded as a set-off, even though the demand which it seeks to interpose as a set-off becomes liquidated after the commencement of the action in which it is sought to be interposed, and as the rule almost universally followed is that a claim sounding in tort is not the subject of set-off, it follows with greater force that a claim for unliquidated damages sounding in tort is unavoidable as a set-off."

The reverse of this rule would be true, that in an action for damages where the damages are unliquidated there can be no off-set of a claim growing out of an independent, disconnected, non-related matter.

It is our contention that this is an action for damages. In this connection we would call the court's attention to *Westervoldt vs. Morenstecher*, a decision by Judge Sanborn of the Eighth Circuit Court of

Appeals reported in 34 L. R. A. 477. This was an action upon the bond of a cashier of a national bank. Judge Sanborn in passing upon the questions involved used this language:

“This is not an action to rescind any contract and recover back the consideration thereof. It is an action for damages for the breach of the conditions of this bond.”

In 9th Wheaton, 220, in *Walton vs. United States*, an action upon the bond of a receiver of public money, the court said:

“The official bond is not given for the balance due; it is a collateral security for the faithful performance of the official duties of the officer, and was executed long before the existence of the balance claimed.”

The Supreme Court of Washington in 19 Wash. 418, in the case of *Spokane County vs. Prescott*, had occasion to pass upon the nature of the liability of a county treasurer's bond. The question directly before the court was when the statute of limitations would commence to run, whether it should be based upon the malfeasance of the officer or upon the written obligation, and the court held that the liability arose when the officer refused to account for the moneys received by him and that it was not based upon the written bond. This case quotes from *State vs. Conway*, 18 Ohio, 235, in which it is said:

“The actual cause of action is not the execution of the bond (that is more in the nature of

a collateral security); but the cause of action is the misfeasance—the false return. Without proof of the false return there can be no recovery. The action is, in effect, although not so in form, an action against an officer for misfeasance in office.”

And the court holds that the bond was a collateral security for the obligation imposed upon the principal. A number of other cases are cited in this decision.

This decision has been cited with approval in a number of later Washington decisions.

In *Dickman vs. Strobach*, 26 Wash. 558, the Supreme Court of Washington in passing upon a guardian's bond used this language:

“Therefore the foundation of the action is not a violation of the terms of a voluntary contract, but is the wrongs committed by the guardian in the violation of his official duties; and the bond is simply a collateral security for the enforcement of the trust.”

In *State vs. Murphy*, 48 Pac. 628, the court observed:

“The Supreme Court of Kansas, in passing upon this question, very correctly held that the wrongs committed by the sheriff in making the levy and sale were the real and substantial foundation of the plaintiff's cause of action, and that the bond was only a collateral security for the enforcement of such cause of action. The bond did not give the cause of action; the wrongs did.”

In *Ruyus vs. Gruble*, 3 Pac. 518, the Supreme Court of Kansas held:

“When the principal debt or cause of action fails, the security must also fail; and, as we have stated before, a sheriff’s bond is merely a security, collateral to the main cause of action.”

In *People vs. Putnam*, Ann. Cases 1913-E, page 1265, the court will find a note where this question is annotated and a number of decisions cited, recognizing the rule that a bond is simply a collateral security for the performance of some duty.

It is contended by counsel that since the statute permits set-offs in certain cases that therefore the off-set in this case would be statutory and not equitable.

The statute does not undertake to define or determine the character or nature of the relief. It is merely a rule of pleadings permitting in certain instances counterclaims and set-offs, and whether the off-set attempted to be invoked is of an equitable nature or not depends upon the case itself and not upon the fact that the statute permits in certain instances off-sets to be plead. The set-off which the defendant is relying upon in this case is of an equitable nature. The right of off-set arises here solely because of the insolvency of the bank. If the bank had not become insolvent no obligation would have arisen on the part of the defendant to pay the depository bond. The whole matter comes before the court on the question of mutual credits and is of equitable

jurisdiction. Without the statute courts of equity were accustomed to grant relief and the statute merely establishes a rule of pleading and still leaves it within the equity branch of the court.

Counsel have cited a number of cases under this head and we will not undertake to review them in detail but we believe that an examination will disclose that none of them bears upon the question now under consideration. The most of them refer to the question of the rights of a surety as against his principal where payment is made by the surety, what rights the surety has as against the principal and do not refer to the particular matter now under consideration. Some of them are questions of application of payment.

Counsel have cited and seem to rely upon the case of *U. S. Fidelity & Guaranty Co. vs. Maxwell*, a recent decision reported in 237 S. W. 708. In this case the bonding company gave a bond to the bank covering dishonesty of the cashier. It also became surety for a depositor in the bank insuring the depositor against loss in the bank.

There is this difference to be noted between that case and the one now before the court, in this instance the plaintiff in error gave a bond to the county treasurer insuring the county against loss of county funds that might be lost in the bank; in the case referred to the bond was given to a depositor in the bank.

Counsel contend that in this case the bond was

given by the bank to the county treasurer and that the defendant became a surety, and in the case cited the bond was given direct to the depositor by the bonding company.

In the case cited, the court says:

“Appellant (referring to the bonding company) had no claim against the Bank of Blytheville and never acquired any claim until it made good its contract of indemnity after the bank commissioner took possession of the affairs of the bank. There was no concurrence between the respective claims of the bank commissioner as receiver under the bond sued on and the claim which appellant acquired by complying with its contract of indemnity with the Missouri State Life Insurance Company.”

So here, there was no concurrence between the liability on the depositary bond which was paid after the bank was taken charge of by the bank commissioner and the bond sued on. At the time the bank failed and prior thereto there existed a liability against the defendant upon the bond given to protect the bank against the dishonesty of the cashier.

When the dishonesty occurred a cause of action accrued and all of the loss which the bank suffered had occurred before the bank failed, and the right of action was complete before the banking officer took charge. At the time the liability occurred this defendant had no claim of off-set merely because of the fact that it had given a bond to the treasurer; it could

have no claim of off-set until it made good its contract of indemnity and it did not make good its contract of indemnity until after the bank became insolvent, and we contend that it could not relate back so as to make concurrence between the respective claims, for the mutuality of the claims must exist at the time of the failure of the bank.

The court is familiar with the rule in this state that when a corporation becomes insolvent that no creditor can be preferred. If the defendant's claim should be allowed it will make it a preferred creditor, for it will be paid in full so far as this bond is concerned, while the other creditors will only receive the dividends, whatever they may be. The purpose of giving the cashier's bond was to protect the bank from suffering loss, the very purpose for which the bond was given, if defendant's contention should prevail, would defeat the objects for which the bond was taken.

In the case cited in 237 S. W., page 708, the court says:

"The law is well settled that where there is a statute prohibiting preferences in claims against insolvent corporations, claims acquired after insolvency or after the appointment of a receiver cannot be set off against debts owing to the corporation in the hands of the receiver for collection, for if the law were otherwise the statute against preferences could be defeated by the purchase of outstanding claims and having them allowed in full as a set-off. The right of set-off

exists only to the extent of the concurrence of the two claims, and in case of insolvency proceedings under a statute prohibiting preferences the concurrence of claims must have existed before the insolvency occurred and the proceedings were instituted."

While our statute does not in terms prohibit preferences, the Supreme Court has established a rule of law in this state which does prohibit preferences. So here before the plaintiff in error should be allowed a preference it must appear that there is a concurrence of claims which must have existed before the insolvency occurred and proceedings were instituted. The insolvency of this bank, according to the testimony of Mr. Adams, had existed for several years prior to the time the bank examiner took charge. The bond to the county treasurer did not become effective until January, 1921.

In *Sawyer vs. Hoag*, 17 Wallace, 610, the Supreme Court of the United States had occasion to pass upon this question of set-off. In referring to the statute which permits set-offs in bankruptcy matters the court said:

"This section was not intended to enlarge the doctrine of set-off or to enable a party to make a set-off in cases where the principles of legal or equitable set-off did not previously authorize it."

The same thing can be said with reference to our statute. It merely puts into statutory form what was previously permitted in legal and equitable actions.

It does not change the fact that one may be legal or equitable; if legal it is legal still, and if equitable it would still be equitable.

The case just cited was a question of whether the indebtedness which a stockholder owed for his stock could be off-set against a debt due him from the company and in passing on that question the court said:

“The debts must be mutual; must be in the same right. The case before us is not of that character. The debt which the appellant owed for stock was a trust fund devoted to the payment of all of the creditors of the company. As soon as the company became insolvent, and this fact became known to the appellant, the right of set-off for an ordinary debt to its full amount ceased. It became a fund belonging equally in equity to all of the creditors, and could not be appropriated by the debtor to the exclusive payment of his own claim.”

That is exactly the situation here. The sum due on the bond to the bank is a trust fund for the benefit of all of the depositors. It does not belong to the bank, it belongs to the depositors. Neither the directors nor officers of the bank would have any right to dispose of that fund after the bank became insolvent in fact. As was said by the court in the case just cited, the demands are not mutual, they are not in the same right, for this fund is a trust fund; there is no question of the insolvency of the bank, no question under the rules followed by the Supreme Court of this

state that all of the property belonging to the insolvent estate is a trust fund to be held for the benefit of all of the creditors.

In *Cook County Natl. Bank vs. United States*, 2 Sup. Ct. Rep. 561, the case from 17 Wallace is cited with approval.

The question here was whether the claim of the United States for moneys deposited in a national bank by the deputy postmaster was a preferred debt, or not, and the court in passing on certain phases of the question said:

“A trustee cannot set off against the funds held by him in that character his individual demand against a grantor of the trust. Courts of equity and courts of law would not allow such an application of the funds so long as they are affected by any trust. It would open the door to all sorts of chicanery and fraud. The fund must be relieved from its trust character before it can be treated in any other character.”

So here, the money coming from the plaintiff in error on this bond is absolutely a trust fund for the benefit of the creditors, and the plaintiff in error is seeking to off-set against that its claim accruing to it from another trust fund belonging to the county.

Quoting further from the last decision,

“This doctrine is well illustrated in the case of *Sawyer vs. Hoag*, 17 Wallace 610,”

and then quoting from that decision,

So we think the conclusion is inevitable that there can be no set-off. There was no mutuality of claims, there was no concurrence of claims, there was no claim of mutuality existing at the time the bank became insolvent. The money due from the defendant on the bond is a trust fund for the benefit of all the depositors and destroys any possible mutuality of claims.

In this connection we would call the court's attention to the fact that the plaintiff in error in this case has presented its claim to the liquidating officer for the sum it paid to the county treasurer and has been receiving dividends upon the claim.

“As a general rule the presentation of a claim against the estate of an insolvent or of a decedent constitutes such an election of remedies as will preclude the subsequent prosecution of an action or suit based on an inconsistent remedial right.”
(20 C. J., page 32.)

And the Supreme Court of Washington held in *Longfellow vs. Seattle*, 76 Wash. 509, that,

“For authority on the proposition that the adoption of one remedy by a person having a choice of remedies bars the right to invoke another, we need not look beyond our own cases.”

In *Clausen vs. Head*, 85 N. W. 1028, in passing on the question of election of remedies the Supreme Court of Wisconsin used this language:

“Having made an election between two

courses with knowledge of the facts he waived the one not chosen."

Quoting further from that decision:

"The doctrine that intent to make a choice between inconsistent remedies is essential to a choice, and that absence of such intent will relieve one from the effect of the rule we have discussed, applied only where action in the first instance was taken in ignorance of the facts. (Citing authorities.) Where knowledge of the facts exists consent is conclusively presumed as a matter of law, and such presumption cannot be affected by any declaration or reservation of a right to take a different and inconsistent course at a subsequent time."

Having elected to accept the dividends with full knowledge of all of the facts the plaintiff in error has irrevocably bound itself to the choice of continuing the relation of debtor and creditor. The court will notice a distinction in the cases where claims have been presented and later withdrawn and instances where claims have been presented and dividends accepted. Here the claim was presented, no effort has been made to withdraw the claim and the plaintiff in error has continued to accept dividends upon its claim. In this connection we would call the court's attention to the case of *Potts vs. Schumacker*, reported in 35 L. R. A. 392.

ITEMS ON WHICH RECOVERY WAS ALLOWED

The court found that the bank had suffered a loss through notes given by H. D. Phillips to the amount of \$4050.00.

The proof established that Phillips purchased a supposed equity in a tract of land near Vancouver, Washington, that was mortgaged for a large sum at the time he purchased it and that he gave a second mortgage to Stewart and that the two mortgages combined equaled the full value of the property. None of the notes represented by any of the mortgages are included in the notes in controversy here.

In addition to giving the mortgage Phillips gave Stewart a large number of notes running into thousands of dollars, some of the notes being made directly to the bank and others to Stewart, but all handled by Stewart. There is no evidence as to what the notes were for or whether there was any consideration for them. Stewart took the notes and turned them in to the bank in one form or another, whether he did it in the form of taking the cash out of the bank and carrying it for a time and then putting in the Phillips notes to take care of it is not material. The fact is Stewart used these Phillips notes for abstracting money from the bank, it was the personal deal of Stewart with Phillips and these notes were evidently procured for the purpose of enabling Stewart to draw money from the bank. In any

event, that is what happened. He knew the value of the land that he sold to Phillips, he knew the Phillips notes were worthless, in addition to that the bank at that time was insolvent according to the testimony and neither he nor the directors were authorized to deal with the funds of the bank in that manner.

On page 231 of the transcript the court will find where Stewart took credit for what is designated as the Henry note in the sum of \$3879.50, less an old Henry note for \$2000.00 and interest and revenue, leaving a net amount of \$1870.16, and on the same page of the transcript it appears that on January 28, 1915, among the deposit slips was a credit to F. L. Stewart of a Henry note of \$2000.00, and on page 232 of the transcript it appears that the Henry note for \$3879.50 was sold by the Kelso State Bank to the American National Bank of San Francisco, and on November 19, 1915, the Kelso State Bank received the note back from the American National Bank and credited that bank with the sum of \$3879.50. On page 233 of the transcript on the same date the guardianship account of F. L. Stewart, guardian of Henry Deering, incompetent, is charged with the sum of \$3879.50. The Henry note, so far as the record discloses, disappears, and the Deering estate was not reimbursed from that day forward except for small deposits, until March 11, 1918. The court will thus see that the Henry note belonged to Stewart and was endorsed and discounted to the bank by Stewart and Stewart was given credit for it, and that after the

San Francisco bank had been unable to realize on the note and returned it to the Kelso State Bank that Stewart then undertook to make the records of the bank balance by taking an equal amount from the Deering estate and charging the Deering estate with that amount and the Deering estate remained in that condition until March 11, 1918, except for a few small deposits; that on March 11, 1918, there was initiated in Stewart's cage book a cash item of \$3200.00 resulting from Stewart withdrawing from the bank on that date the sum of \$3200.00 and using it for some purpose and the amount was then carried from day to day as a cash item or as the proverbial "I. O. U.," which was merely a fiction to make his cash balance. On that date, March 11, 1918, the deposit ticket of F. L. Stewart reads, "Cannery mortgage \$3200.00, Loaned Deering \$3000.00, Net \$200.00." On page 230 of the transcript it appears that on March 11, 1918, the guardianship account of Henry Deering was credited with \$3000.00. This cash item of \$3200.00 is carried from day to day until March 20, 1918, when two notes of H. D. Phillips, each for \$1500.00, were discounted to the bank and the cash item went out, Stewart putting in in addition to the notes his individual check for \$200.00, as shown on page 230 of the transcript. It appears from this that Stewart originally had acquired possession or ownership of the Henry note, that he discounted this to the bank and received credit for the full amount of its face value; the bank negotiated the

note to the California bank but later received it back and credited the California bank with the amount and in order to meet this liability and make his books balance Stewart drew from the Deering estate for which he was guardian and placed that amount in the bank; later, in order to settle with the Deering guardianship matter he took from the bank cash and carried it as cash items until the Phillips notes came in, when they were turned in to the bank for \$3000.00 and Stewart gave his own check for \$200.00 and the cash item was eliminated. The Phillips notes were worthless and grew out of a transaction that Stewart had with Phillips, the bank losing \$3000.00 through this manipulation of Stewart's.

The court found the total liability on account of the Phillips notes was the sum of \$4050.00.

We think an error has occurred in the amount of these Phillips notes. The finding of a note of H. D. Phillips for the amount of \$550.00 of date March 20, 1918, should be for \$50.00. It appears from the transcript (pp. 157-158) that this note was for \$550.00 and was handled by Stewart, but Stewart only took credit personally for \$50.00 of the amount, the other \$500.00 mentioned in the findings was discounted by Stewart to the bank and Stewart took credit for the full amount; this will be found on pages 158-159, making a total charge on account of the Phillips notes of \$3550.00, instead of \$4050.00, as found by the court.

FRANK SHEPARD NOTES

The court will find by reference to the testimony of Frank Shepard (transcript pp. 358-377) that Frank Shepard purchased from Stewart a half interest in the Northwest Transportation Company, agreeing to give him \$15,000.00 for a half interest, giving him \$1000.00 cash and fourteen notes for \$1000.00 each. He was dealing entirely with Stewart and had no dealings with the bank, and these were the only notes given by Shepard to Stewart or to the bank, except renewals, and are some of the notes involved in this controversy. The notes may have run directly to the bank but were the notes which Stewart received from the sale of his interest in the Northwest Transportation Company, the blank forms of the bank merely being used in the making of the notes.

On March 5, 1920, a note given by the Independent Navigation Company for \$7500.00 was taken up from the proceeds of the Frank Shepard fourteen notes on that date (transcript p. 396). The Independent Navigation Company was another company operated and controlled by Stewart as appears from the testimony of W. F. Magill (transcript pp. 250-280), referring particularly to pages 266, 273 and 274 of the transcript. The Independent Navigation Company note, as appears from the testimony of Dunham (pp. 394-396) was a Stewart note, Stewart getting the proceeds of the original note for \$500.00 and at each subsequent renewal for a larger amount

the difference was credited to Stewart, and in this connection we would call the court's attention to the testimony of Dunham (p. 395) that Stewart was reimbursed for the \$2160.00 which he temporarily applied to the Cowlitz Bridge Company indebtedness.

Of the \$14,000.00 represented by the fourteen Shepard notes that were turned in to the Kelso State Bank, \$7500.00 and interest to the amount of \$376.67 was used to take up the Independent Navigation Company note, which was a Stewart note; \$2160.00 was used to take up temporarily a Cowlitz Bridge note, which was later reimbursed to Stewart by the Cowlitz Bridge Company, as shown on page 395 of the transcript, and Stewart was credited with the balance of the \$14,000.00. This establishes that he got the benefit of the whole \$14,000.00 of the Shepard notes.

Of the notes that the bank took in, \$6000.00 was transferred to the United States National Bank of Portland; these notes were renewed from time to time as appears from the testimony of Frank Shepard (pp. 358-377); some of these renewal notes were later discounted to the Kelso State Bank and constituted the \$4000.00 note involved in this controversy. Pages 162-164 of the transcript show that these notes were again turned in to the bank and that Stewart got credit for them.

On page 196 of the transcript the notes referred to on pages 162-163 are traced into the notes which

were admitted in evidence and which were found among the assets of the bank when the liquidating officer took charge. The liquidating officer received on the \$4000.00 note a 20 per cent dividend from Shepard, leaving a balance of \$3200.00 which the bank lost and which occurred through the Shepard notes as manipulated by Stewart.

NORTHWEST TRANSPORTATION COMPANY NOTES

It will appear from the testimony of Mr. Magill (transcript pp. 250-280) that Stewart owned the stock of the Northwest Transportation Company and was the active manager of the affairs of the company. He sold an interest in it to Shepard and the company was operated by Stewart and Shepard (see also testimony of Shepard pp. 358-377). During all of the time involved here Stewart was the active manager of the corporation and was thoroughly familiar with its business and financial affairs.

Counsel on page 39 of their brief admit that the testimony established that Stewart was a stockholder in the Northwest Transportation Company and they admit that the \$2500.00 found by the court was for money which Stewart loaned to his own company, taking its note, and then discounting the note to the bank, Stewart getting the money for the note and the bank losing the \$2500.00. This transaction was in direct violation of the law, was in effect an abstraction of the funds of the bank by Stewart, and falls clearly within the inhibitions of the banking act as

well as constituting an embezzlement of the funds of the bank under the decision of the Supreme Court of Washington in *State vs. Larson*, 22 Wash. Dec. No. 10, p. 471.

The \$5000.00 note, of which \$2104.78 was charged against the plaintiff in error, was of the same character. It was given to Stewart by himself as a representative of the corporation, and for money which Stewart had advanced to the credit of his own company, and was discounted to the Kelso State Bank, Stewart getting the money and the bank losing it.

Counsel state in their brief, on page 41, that the bank held a mortgage on the Steamer "Olympian" as security for these notes. Counsel were not justified in making that statement. There is nothing in the record to justify it, and it was not true. The bank held no security for the notes involved in this controversy. It held security on the steamer "Olympian" for a \$5000.00 note given by the Northwest Transportation Company, which was closed at a loss of about \$2700.00, as shown on page 384 of the transcript.

It further appears from the testimony of Mr. Adams (pp. 384-5) that the bank held notes of the Northwest Transportation Company at the time it went into liquidation, amounting to \$12,750.00, and that a number of notes of that company came into the bank subsequent to the closing of the bank which have been sold with recourse, aggregating altogether

\$19,750.00. The bank has realized \$2300.00 on the steamer "Olympian" and will suffer a total loss on the balance, except what may be recovered in this litigation.

THE FRITZ KRUSE NOTES

Fritz Kruse testified (transcript pp. 282-287) that he gave a note to either Stewart or the bank for \$5000.00. He stated that it was given at the request of Stewart and without consideration for the purpose of helping Stewart. This note was discounted by Stewart to the bank, as will appear from the testimony of Mr. Adams (pp. 159-160), and Stewart received credit for \$4880.00. According to the testimony of Mr. Kruse (pp. 284-285) about three months after the giving of the \$5000.00 note the \$5000.00 note was surrendered to him and he gave two notes to Stewart, each for the sum of \$2500.00. The court will find on pages 189-190 of the transcript referring to these notes that the \$5000.00 note of Fritz Kruse was renewed by the giving of two \$2500.00 and these two \$2500.00 notes are the ones that were admitted in evidence in this case and found among the papers of the bank when the examiner took charge. Mr. Kruse testifies that he paid nothing on any of these notes. Counsel contend that the \$5000.00 note was paid. The bank received nothing. Stewart had received \$4880.00 in the beginning, and when the \$5000.00 note became due it was renewed by the giving of the two notes for \$2500.00 each; the bank received nothing and Kruse paid nothing.

THE T. P. FISK NOTE

The facts about this note are that Stewart had an agreement with Fisk to carry Fisk's interest in a certain investment. This agreement was admitted in evidence and is one of the exhibits in this case. Under that agreement it appears that Fisk had no money to go into the deal and that it was agreed that Mr. Fisk should have a one-sixth interest in the project, provided he could raise the money, and Mr. Stewart agreed to furnish the money and they would divide the profits. There was no understanding that Fisk was to furnish any of the money but it was to be furnished by Stewart. When the bank failed a note made out by Stewart was found among the papers of the bank with Fisk's name upon it, but it is conceded that it was not signed by Fisk.

It appears from the testimony of Judge McKenney that Stewart shortly before the bank failed wanted Fisk to sign the note and he refused to do it. On page 350 of the transcript Judge McKenney testified as follows:

“Q. You wrote the agreement or did Fisk write it?

A. I do not remember at this time.

Q. After that agreement which is in evidence was made, did you hear any conversations between Stewart and Fisk?

A. I did.

Q. What were they?

A. Stewart was insisting that Mr. Fisk come to the bank and give his note for that amount of money which Fisk refused to do and they had practically a quarrel over it and Mr. Fisk went away very angry about it, and he came back and renewed it afterwards. Fisk finally told him he would give the note if he would embody in that note all the conditions that were in the contract, but it was never carried out. He never gave any note up to the time Stewart disappeared."

It is not denied but what Stewart drew the money direct from the bank and used it in this enterprise; it was a private affair, a private investment in which the bank was in no manner interested. It was a taking of the money from the bank by the cashier without any authority and in direct violation of law.

Counsel say the bank acquired an equitable lien in Fisk's share in the Shillapoo project and should have received Fisk's stock. Counsel know that that was not the agreement; the bank acquired no interest, received nothing, and will receive nothing on that account.

Counsel undertake to avoid the effect of this action of Stewart's by charging that the cashier and other officers had violated the law by taking money from the bank without authorization. There can be no justification or ratification of an illegal criminal act.

Counsel say that there is no evidence that the bank lost any money. The amount was credited to Stewart and it appears in the testimony that when Stewart disappeared and the bank failed that he was \$200,000.00 in debt with no assets of any consequence.

KELSO FARM COMPANY NOTES

It is admitted that the Kelso Farm Company was Stewart's farm and was merely a trade name. Counsel undertake to justify this abstraction of the bank's funds by Stewart of \$5950.00 by saying that a resolution was passed at a meeting of the directors on January 11, 1921, authorizing a loan of \$6000.00 to Stewart. There was no resolution passed in the manner required by law and no resolution passed referring to this loan or any loan involved in this litigation. The \$6000.00 referred to in the resolution of January 11th was in the claim presented to plaintiff in error, but was not pressed because of the resolution of the board of directors. The resolution made no reference to any of these loans, had nothing whatever to do with the loan to the Kelso Farm Company, but referred entirely to another matter.

Counsel again repeat that the bank lost nothing by this money which Stewart took from the bank and used for private purposes. The bank suffered a loss of the entire amount and it was embezzled from the bank by Stewart and clearly falls within the provisions of the bond.

THE RICHTER WARRANTS

Counsel urge that the Court was in error in allowing a recovery on the Richter estate warrants.

No claim was made on account of these warrants when the claim was presented to plaintiff in error. These warrants belonged to the Phillip Richter estate. Stewart was administrator of this estate; he took these warrants from the estate, discounted them to the bank, and took personal credit for \$2000.00 representing the face value of the warrants. (See transcript, pp. 177-182.) After the bank passed into the hands of the bank examiner he was compelled to surrender these warrants to the lawful owner and thereby lost the \$2000.00. This loss was not discovered until after the main claim had been presented to the bonding company.

Stewart's relations with the bank ended when the examiner took charge, he was not connected with it thereafter. A notice of defalcation could not affect the company's liability because he was no longer connected with the bank, all defalcations had occurred previously and the company could not have been injured in any manner whatsoever by the failure to give notice of this particular claim. The company did have notice of a large claim made by the liquidating officer against the company. The attorneys for the company made an extended investigation following the closing of the bank and examined in great detail all of the books of the bank and also discovered the true situation about these warrants, entered into a stipulation

with reference to the warrants. Under these circumstances the giving of a notice to them would have been wholly useless and of no value or importance to them; it could not have in any manner affected their legal rights.

In 19 Cyc., 522, the rule is given as follows:

“It is very usually stipulated in policies or bonds of the nature under discussion, as a condition precedent to a recovery thereon, that the insured shall, upon the discovery of any default or loss, immediately give the insurer notice, in writing. Such a stipulation has, however, been construed to require, not that notice should be given to the insurer instantly on the discovery of a default or loss, but merely that such notice should be given within a reasonable time thereafter, having in view all the circumstances of the case. Such notice may be waived by the insurer, or a waiver may result from the acts of the insurer’s authorized agent.”

There has been a denial of liability in this case from the beginning. The defendant company through its attorneys made an exhaustive examination of the records of the bank, the claim was presented for a very large amount and payment refused and this action was commenced. These items were discovered after notice of the main claim was given, so it is our contention that the company waived any objection to including this item in this action and that including it in the complaint was sufficient notice; in any event it would only affect the question of costs.

If the court should construe the bond to be a statutory one then it was not necessary to present any claim. It is only in the event that it should be construed as a contract bond that this question becomes important, and then we claim that under the facts as disclosed in this record that the plaintiff in error was not prejudiced in any manner by the failure to be formally notified of this claim. The attorneys for plaintiff in error knew of this claim long before this action was commenced.

COMMON LAW BONDS

It is our contention that after the passage of the banking act by the legislature of Washington in 1917 that the bond became an official statutory bond.

Section 32 of chapter 80 of the banking act of the State of Washington provides that the board of directors of each bank shall require its active officers and employees to give a surety company bond in such sum as the board shall specify, and the state bank examiner shall approve it, conditioned for the faithful and honest discharge of his duties and for the faithful application of all moneys, funds and valuables which shall come into his possession or under his control.

Section 7246 of Remington's Compiled Statutes of Washington for 1922, being Section 6059-193 of Remington's Code, authorizes bonding and casualty companies to furnish bonds of this character, and Section 777 of Remington's Compiled Statutes for 1922 provides that no bond required by law, and intended

as such bond, shall be void for want of form or substance, recital, or condition; nor shall the principal or surety on such account be discharged, but all the parties thereto shall be held and bound to the full extent contemplated by the laws requiring the same, to the amount specified in such bond.

These statutes inevitably lead to the conclusion that it was the duty of the officers of the bank to take a bond from the cashier and that if a bond had been required from the cashier and it had been furnished in compliance with the requirements of the statute it would have become an official bond governed by the laws applicable to official bonds. The question arises here, does the fact that this bond had been previously given and was renewed after the passage of the law and continued in force by renewals until the bank became insolvent, and in the absence of a showing that it was furnished directly in response to the requirements, make it a contract bond and relieve it from the character of an official bond?

The law presumes that the officials performed their duty and in the absence of a showing to the contrary the court must conclude that the bond was furnished as required by law. The directors could very well have concluded that no action on their part was necessary as the bond was in force at the time of the passage of the law and was thereafter annually renewed. The fact that some officer or officers of the bank may not have performed their full duty in regard to this bond would not change its character or

relieve the defendant from liability. The fact, also, that the bond did not contain the statutory conditions would not release the liability fixed by statute, for the law is read into the bond and all parties must take notice of the conditions of the bond as required by law.

Counsel seem to place great reliance upon the case of *Puget Sound State Bank vs. Gallucci*, 82 Wash. 445.

We have read this case with care and we cannot see any possible application of the decision to the question now before the court. It in no manner discusses the question now before the court and it was in no way involved. The language quoted in counsel's brief clearly proves that the decision has no application. In that case a bond was furnished in pursuance of the statute requiring bonds to be taken for public work. The bond contained the statutory requirements and then as construed by the Supreme Court some additional language binding it to pay certain liabilities which were not required by the statute, and the court merely held that having gone further than the statute required and entered into what the court construed to be a contract with the bank, it became obligated to pay the bank according to the terms of its contract. The question of whether it was a statutory bond, or not, was not before the court. The only question that was involved so far as this matter was concerned was whether having gone beyond the requirements of the statute and obligated

itself to perform more than the statute required it could be held to the performance of the terms of its contract and the court held that having voluntarily assumed the obligation that it could not avoid payment. The question here is not whether this company has gone beyond the contract, but whether this should be construed to be a statutory bond or a common law bond. The law will presume that the bond was given in pursuance of the statute. It is not in the exact language of the statute, but it covers substantially the same matters.

The statute requires that the bonds shall be conditioned for the faithful and honest discharge of the duties of the officer and for the faithful application of all moneys, funds and valuables which shall come into his possession or under his control. The condition in the first bond was to cover losses sustained by any dishonest act or acts committed by the employee in the performance of the duties of his office, and in the second bond given the conditions were to cover losses sustained through the fraud, dishonesty, forgery, theft, embezzlement or wrongful abstraction, directly or in connivance with others, of the employee, etc.

The court will notice that the statute requires a bond conditioned for the faithful and honest discharge of his duties and for the faithful application of all funds, while the latter bond covers fraud, dishonesty, forgery, theft, embezzlement or wrongful abstraction,

and the first bond is for dishonest act or acts committed by the employee.

There is substantially no difference in the requirements of the statute and the bond. They cover the same losses, the same dishonesty, and are intended to reach the same liabilities and to protect the bank against the same losses. There is a very wide distinction between those cases where it is the mere use of words meaning substantially the same thing and the Gallucci case where the company had gone beyond the statute and entered into a contract of additional liability.

Counsel cite *Western C. & G. Ins. Co. vs. Muskogee County*, L. R. A. 1917-B, page 977. If the court will read this case it will discover that the language used by the court was a mere statement of the court not in issue in that case and was contrary to the doctrine of the decision and to the authorities cited by the court.

The court in that case held that one who guarantees by bond the payment of public funds deposited in a county depository under the statute could not defeat liability on the bond by saying that the designation of such bank was irregular or illegal, and further, that where a bond was executed pursuant to the statute containing the conditions required and in addition other conditions not required by statute tending to limit or evade liability, the bond would be upheld as to the conditions imposed by the statute and the other provisions would be treated as surplusage.

So that decision is an authority in our favor for it holds that where in a statutory bond conditions are inserted which tend to limit or evade liability that the courts would construe it as a statutory bond and uphold it as to the conditions required by statute. And in that decision there is cited and quoted from the Supreme Court of New York this language:

“Where the form of an official bond differs from that prescribed in the statute, if founded upon a good consideration, the liability of the surety is measured by the provisions of the statute rather than the language of the obligation itself.”

In *Southwest Surety Insurance Co. vs. Davis*, 156 Pac. 213, the court held that until the contrary is made to appear the law presumes that officers have discharged the duties which the law imposes upon them.

In this case the court held that to give the language of the bond a literal interpretation would render it ambiguous and nugatory and relieve the surety from all liability * * * the bond sued on, being a statutory one, and given in an attempt to comply with the statute, in order to avoid such a result, the court will read into the bond the statutory conditions and consider the same to guarantee the fulfillment of contracts entered into within the year.

In *Board of County Commissioners vs. Security Bank*, 77 N. W. 815, the Supreme Court of Minne-

sota in passing on a bond furnished by a bank designated as a depository county bond used this language:

“It is familiar law that in taking a bond from a public officer to secure the performance of his official duties the state or any municipal sub-division of it, does not contract with the sureties against the negligence or misfeasance of other public officials in the performance of their duties designed for the benefit and protection of the public, and hence that such negligence or misfeasance will not release the sureties, although the due performance of such duties might have prevented loss to the public caused by misfeasance of the principal on the bond, and thereby also prevented loss to the sureties. One of the most common examples of the application of this rule is where some public officer or board, having a supervisory power over another officer, has failed to perform his or its duty by examining the books and vouchers of the principal obligor on the bond, or by requiring him to make reports or settlements at stated periods as required by law.

* * * And it is the general rule as to suretyship on official bonds, given to secure the public, that the negligence or misfeasance of other public officials is not chargeable to the public.”

So in the matter now before the court, if the bond is to be held to be an official bond then the negligence or misfeasance of the board of directors would not affect the bond or release it from liability.

We desire to call the court's special attention in this connection to the case of *U. S. Fid. & Guaranty*

Co. vs. Fred H. Poetker, reported in L. R. A. 1917-B, p. 984.

Counsel undertake to avoid the force and effect of this decision by the statement that the bond contained all of the conditions of the statute and some additional provisions, but the real question before the court in that case was the same question now before the court in this case. To bring the question involved in that case before the court we quote:

“In the main the questions raised by appellant surety company are based upon the assumption that the bond which was executed for Behrens to secure to the bank the faithful discharge of his duties as its cashier is a common law undertaking and that a recovery on it can be sustained only according to the numerous and intricate provisions and conditions contained in it and the written application for it. In behalf of appellee it is claimed that the bond must be held to be a statutory official bond legally of a character and with such conditions only as the statute provides.”

The court will see from this that the surety company was attempting to avoid liability because the bond which it furnished to the cashier contained numerous conditions not required by the statute. That is what the company is seeking to do here. It is true that it does not appear that the bond in this case was furnished directly in pursuance of the statute, but it is our position that it was the only bond given and

that it took the place and should be given the force and effect of a statutory bond.

Quoting further from that decision:

“It will be noted that while this statute leaves the amount of the bond to be fixed at the discretion of the board of directors, it is mandatory upon them to exact a bond from each of the officers named and by its terms states the simple condition upon which it must be given in clear and unmistakable words; namely, that the officer will honestly and faithfully discharge his duties as such officer during his continuance in office. Such a plain and simple obligation with the broad and comprehensive condition the statute requires and one less direct and less burdensome for the surety does not satisfy it.

“A bond such as the one given in this instance which is manifestly prepared with studied care to avoid all liability on the part of the surety except such as might grow out of a loss that might occur to the one to whom the bond was given, even after he had exercised that close and relentless vigilance which makes stealing well nigh impossible, certainly does not fulfill the requirements of the statute.”

Again quoting from this decision:

“It has been frequently decided in this state that bonds taken pursuant to a requirement of a public statute are official bonds within the meaning of this section of the statute. * * * It has also been held that the provisions of the statute requiring the bond to enter into and become a

part of the bond, whether written in it or not, and constitute the contract upon which both the rights and the liabilities of the surety are to be determined. * * * And quoting from Childs on Suretyship and Guaranty, Sec. 91, p. 22:

“The general rule is, that where a contract of suretyship is entered into pursuant to a statute or to a by-law, the statute or by-law forms a part of the contract of the surety. If the law has made the instrument necessary the parties are deemed to have had the law in contemplation when the contract was executed. Citing authorities.’ ”

Again quoting from the Poetker decision:

“It would be immaterial whether such bond is in terms payable to the state. The law makes it so payable. It would be immaterial to the surety’s liability whether Parks executed it. The surety is liable whether he did or not. And it is immaterial that the instrument, though signed by Parks, yet on its face imports no obligation on his part to the state. The law imports that obligation into the bond. On the other hand, no account is to be taken of, and no operation is to be given to the several stipulations and conditions set down in this paper which tend to eliminate the liability which the official bond imports, or to clog or impeach the remedy for the enforcement of such liability. The right of recovery is the same in the abstract and as to the amount as if the bond had expressed the statutory conditions, and those only; an action upon it is maintainable under the same condition.”

We think that this case is controlling of this question and that the court must conclude that the bond in this case should be treated as an official bond and the liability of the plaintiff in error determined upon that basis.

BREACH OF WARRANTIES

It is contended by counsel that plaintiff cannot now recover because at the time when each renewal was given the president of the bank signed a certificate certifying that Stewart had faithfully, honestly and punctually accounted to him for all money and property in his control or custody as an employee of the bank, and had always had proper securities and funds on hand to balance his accounts and is not now in default.

The court will discover from a reading of the record that Carothers, the president, had no knowledge of any misdeeds by Stewart. Stewart had not taken money directly from the bank except in the loans to himself.

The acts of Stewart for which we are seeking to hold the plaintiff in error responsible are the negotiating his own notes to the bank and loaning money to himself. Carothers may not have known it was illegal and so far as he knew Stewart was honest and acting in good faith. There was no question but what the funds on hand were correct, his accounts always balanced. From Carothers' standpoint and knowledge he was telling the entire truth; there was no inten-

tional misstatement of any fact, no fraud practiced by Carothers, he told the truth as he understood it.

We contend, however, that Carothers had no right or authority to make any such certificate and it is immaterial what he stated so far as this case is concerned.

On this point we would call the court's attention to the case of *American Surety Company vs. Pauly*, where the Supreme Court of the United States held that the president of a national bank had no power in the ordinary course of business to certify to the fidelity or integrity of the cashier for the purpose of enabling him to procure a bond insuring his fidelity; and hence, the bank cannot be deemed, merely by virtue of the president's relation to it, to have any knowledge of the giving by him of such certificate. In passing on this question the court said:

"But that the making of a statement as to the honesty and fidelity of an employee for the benefit of the employee and to enable the latter to obtain a bond insuring his fidelity, was no part of the ordinary routine business of the bank president and there was nothing to show that by any usage of this particular bank, such function was committed to its president. It must therefore be taken, as between the bank and the company, that the former cannot be deemed, merely by reason of Collins' relation to it, to have had constructive notice that he, as president, gave the certificate in question."

So, in the case at bar, there is nothing in this

record that the directors or other officers of the bank ever had any notice or took any part in the giving of the certificate that Carothers gave. There is nothing to show that they knew anything about it or that anyone knew anything about it except Stewart, who was giving the bond, and Carothers. Stewart's knowledge could not be construed against the bank for he was the party giving the bond, and Carothers' knowledge under the decisions cited was not the knowledge or act of the bank.

In *Fidelity & Deposit Company vs. Courtney*, 22 Sup. Ct. Rep. 833, the Supreme Court of the United States held that in a suit against a surety on the cashier's bond a plea that the cashier's defalcation was known to and connived at by the officers of the bank was held to be no defense and that the knowledge of the vice-president and one or more of the directors but less than a majority of the board of a default by the president was not rendered imputable to the bank so as to relieve the surety on the bond from liability.

We contend further in this connection that even though Carothers had authority to give the certificate that the matters contained in the certificate were not warranties but mere statements of fact.

In *Lieberman vs. First National Bank*, 48 L. R. A. 514, the Supreme Court of Delaware held that statements made by the cashier of a bank without authority for the purpose of inducing a person to become the surety on the bond of a teller would not bind the bank

so as to relieve the sureties if the statements were not true.

In *Title Guaranty & Surety Co. vs. Nichols*, 32 Sup. Ct. Rep. 475, the Supreme Court of the United States in passing upon this question used this language:

“It is said that this statement was untrue, in as much as, at the date of such renewals, the books and accounts were not correct and the cashier was short in his cash. But the certificate is not to be taken as a warranty of the correctness of the accounts. The mere fact that the examination, if made by a reasonably competent person, failed to discover discrepancies covered up by false entries or other bookkeeping devices would not defeat the renewal. The case at this point went to the jury upon the fact of reasonable examinations and the good faith of the bank in making the representation.”

In *Remington vs. Fidelity & Deposit Co.*, 27 Wash. 429, the Supreme Court of Washington in passing upon this question held that

“In the absence of a showing of fraud in obtaining an extension the certificate was merely a representation of a fact and not a warranty of its truth.”

Applying this rule to the facts before the court it is clear that the certificate given by Mr. Carothers was furnished in the utmost good faith. There was no fraud practiced by him and no intentional wrong on

his part. That being true, it would not become a bar to a recovery but would be left as a question of fact for the court.

We would also call the court's attention to the clear distinction between what occurred before the original bond was given and at the time it was given and the conditions contained in the original bond and the certificates of Mr. Carothers for renewals.

No question is urged that the statements made in the application for the bond were untrue or false, or that the Surety Company should be released because of anything occurring at the time the bond was given. There is no claim of fraud on the part of Mr. Carothers when he signed the renewal certificates. There is no showing in the record of fraud on his part. While Mr. Carothers was nominally president of the bank he exercised no management or control over the affairs of the bank; he was operating a store, gave little or no attention to the affairs of the bank, trusted to Stewart entirely, and signed the certificates for renewal each year without any sort of showing of actual knowledge or intentional fraud. This would leave the renewal certificates as merely representations of fact and not warranties.

RATIFICATION

Counsel contend that the officers of the bank by their conduct have ratified the illegal loans and unlawful abstractions of Stewart.

It is our contention that under the act of 1917 there can be no ratification of an illegal act; but whether that is so, or not, there is no evidence at all in this case of any ratification, directly or indirectly, by the board of directors of any of these loans in question in this case.

The very most that can be said about it is that some of the directors had borrowed money from the bank illegally; some of them might have known of Stewart's illegal borrowing and illegal transactions, but knowledge on their part of illegal and unlawful conduct on Stewart's part in using the money in the bank for private purposes connected with his private undertakings could not possibly amount to a ratification.

There is an early decision by the Supreme Court of the United States which we think has a very important bearing upon this case. We refer to the case of *Minor vs. Mechanics' Bank of Alexandria*. In the edition we have it is Volume 7, 12th Wheaton, 1 Peters, page 445. Quoting from that decision:

"The question then comes to this, whether any act or vote of the board of directors, in violation of their own duties and in fraud of the rights and interest of the stockholders of the bank, could amount to a justification of the cashier, who was a *particeps criminis*. We are of opinion that it could not. However broad and general the powers of the direction may be for the government and management of the concerns of the bank, by the general language of the charter and by-laws,

those powers are not unlimited, but must receive a rational exposition. It cannot be pretended that the board could, by a vote, authorize the cashier to plunder the funds of the bank, or to cheat the stockholders of their interest therein. No vote could authorize the directors to divide among themselves the capital stock, or justify the officers of the bank in an avowed embezzlement of its funds. The cases put are strong, but they demonstrate the principle only in a more forcible manner. Every act of fraud, every known departure from duty, by the board, in connivance with the cashier, for the plain purpose of sacrificing the interest of the stockholders, though less reprehensible in morals or less pernicious in its effects than the cases supposed, would still be an excess of power, from its illegality, and, as such, void as an authority to protect the cashier in his wrongful compliance. Now, the very form of these pleas sets up the wrong and connivance cannot for a moment be admitted as an excuse for the misapplication of the funds of the bank by the cashier."

This decision was written by Judge Storey. It was upon a cashier's bond given to the bank and contained the condition that the officer would well and truly execute the duties of cashier. It is true that this bond did not contain, so far as the case discloses, the numerous conditions found in the bonds in the case now on trial, but it is our contention that the same principle would apply to the conduct and actions of the directors as in the case just cited. And in this connection we desire to call the court's attention to

this thought, that if the bank was insolvent to the extent shown by the testimony of Mr. Adams then neither the cashier nor the directors would be justified or authorized in making a loan to one of its own officers, either directly or indirectly, and any attempt to do so would have been in violation of the law and would fall within the doctrine announced in the decision just cited. This decision has been cited, approved and followed in a number of recent decisions of the same court.

It would be illegal and dishonest to permit a board of directors to authorize a loan to one of its own officers at a time when the bank was clearly insolvent and in need of finances to carry on its business and meet its obligations and an attempt to do so would be dishonest and in violation of law.

In Enc. of U. S. Supreme Court Decisions, Vol. 3, p. 99, the following rule is given:

“The official bond of a cashier must be construed to cover all defaults in duty which are annexed to the office from time to time by those who are authorized to control the affairs of the bank, and the sureties in the bond are presumed to enter into a contract with reference to the rights and authorities of the president and directors under the charter and by-laws. It obligates not only to honesty, but to reasonable skill and diligence, covers wilful or permissive misapplication of the bank’s funds and default cannot be excused by any act or vote of the directors in violation of their duties; such as an attempted

sanction of an usage to allow overdrafts, or in the absence of express agreements, by the laches or negligence of the directors, not amounting to fraud or bad faith, or by the connivance of ordinary agents or employees.”

The above is taken from the work mentioned and is supported by citations from decisions of the Supreme Court of the United States.

Clearly, the discounting of notes in which Stewart was personally interested would be in violation of his duties as cashier of the bank and would amount to a wilful misapplication of the bank's funds.

In *McShane vs. Howard Bank*, 10 L. R. A. 552, quoting:

“The directors are not the creditors; the body corporate is. If the directors were derelict in not giving notice to the sureties or if the directors ever connived at the fraud of Sidgaway the sureties of the latter cannot claim exemption because of the neglect or misconduct of other officers. It is a sound principle that the failure of one officer of a corporation to discharge his duty does not release the sureties of another from responsibility for the defaults of the latter.”

In *Am. Surety Co. vs. Pauly*, 18 Supt. Ct. Rep., 552, the court held that if the bond of a fidelity insurance is fairly and reasonably susceptible of two constructions that most favorable to the insured must be adopted; because the instrument was drawn by the attorneys, officers or agent of the surety company.

In *German Savings Bank of Des Moines vs. Des Moines National Bank*, 98 N. W. 606, the court used this language:

“It is elementary that an agent cannot bind his principal, even in matters touching his agency, where he is known to be acting for himself or to have an adverse interest.”

From 9 L. R. A. (N. S.), page 471, we take this from the note:

“The decision in *First National Bank vs. Gunhus*, is based upon the well established principles that a bank cashier, although possessing broad powers pertaining to the management of the affairs of the bank, cannot deal with the assets thereof for his individual benefit, as his fiduciary relations therein cast upon him the duty of exercising the utmost good faith and fairness in all his personal transactions with the bank, and that a debtor cannot, without the express agreement and consent of his creditor, cancel his debt by the substitution of a note or obligation of a third person therefor; nothing but money, in the absence of express agreement, being sufficient cancellation of the debt. Neither can the cashier represent both himself and the bank in a transaction wherein he is personally interested.”

In *Mendel vs. Byrd*, 99 N. W. 493, it is held that the general authority of a cashier does not authorize him to issue drafts of the bank for himself or for his private use. See also: *Kochler vs. Dodge*, 47 N. W. 913; *Buffalo Co. Bank vs. Sharpe*, 58 N. W. 734.

“An officer cannot act in a transaction in which he is personally interested for both parties, and should he do so his acts would not bind the bank and would become valid only through implied or express ratification. The sale of a note by the president or cashier of a bank of which he is manager can never be valid without some act of the directorate.” 5 Cyc. 466.

See also *Adolph Kempner vs. Citizens Bank*, 116 N. E. 441. We would call the court’s attention to this language:

“The law will not permit a conflict in this way between his interest and his duty and removes the temptation to wrong by absolutely disabling him in such a case from acting for himself and at the same time for his principal.”

Also, in *West St. Louis Savings Bank vs. Shawnee County Bank*, 95 U. S. 557, it is held:

“The cashier of a bank is not presumed to have power by reason of his official position to bind his bank as an accommodation endorser of his own promissory note.”

In *Fidelity & Deposit Co. vs. Courtner*, reported in 22 Sup. Ct. Rep. 833, the Supreme Court of the United States in passing upon the bond of an officer of a bank in an action by the receiver used this language:

“It is well settled that, in the absence of express agreement, the surety on a bond given to a corporation, conditioned for the faithful perform-

ance of an employee of his duties is not relieved from liability for a loss within the condition of the bond by reason of the laches or neglect of the board of directors, not amounting to fraud or bad faith, and that the acts of ordinary agents or employees of the indemnified corporation conniving at or co-operating with the wrongful act of the bonded employee, will not be imputed to the corporation."

The facts in the case now before the court disclose that Stewart had general management and conduct of the affairs of the bank; the directors met occasionally and Stewart made reports from time to time of what purported to be the condition of the bank. These reports were accepted by the directors, apparently, as being correct and truthful and as showing the real condition of the affairs of the bank. And it now appears that during this time that the bank was actually insolvent and known to be insolvent by Stewart but not by the directors or president of the bank.

The testimony also shows that other officers had from time to time borrowed money from the bank and that Stewart had been borrowing from the bank. The most that can be charged against the conduct and action of the directors was that of laches and neglect. There was no proof, and indeed, counsel did not contend during the trial of the case, that the directors had been guilty of fraud or bad faith. They may have been misled by Stewart, they may have been guilty of laches and they may have been guilty of neglect, but no other inference can be drawn from the the entire

case; no one can contend that the directors were guilty of actual fraud or intentional bad faith. What they did was in good faith, trusted to Stewart, accepted his reports at full face value, and continued to permit him to conduct the business of the bank. They may be responsible to the depositors for their negligence and inattention, but that does not release the surety upon the cashier's bond; before that can be done it is necessary for it to clearly appear that they were guilty of fraud or misconduct amounting to bad faith.

American Surety Company vs. Pauly, 18 Sup. Ct. Rep. 522, was an action upon a surety bond given to a bank by the cashier. On the question of the duty of the bank to notify the surety of the dishonest acts of the cashier the court held that the bank was not required to give notice based upon suspicion of irregularities or suspicion of fraud, but that it was not bound to act until it had acquired knowledge of some specific fraudulent or dishonest act which might involve the defendant in liability for the misconduct. On this point see also

Fidelity & Casualty Co. vs. Bank of Timmons-ville, 71 C. C. A., 229; 139 Fed. 101.

In *Lieberman vs. First National Bank*, 48 L. R. A., reading from page 519, the court held that there was no positive duty resting on the officers of the bank to investigate with a view to inform the surety in the absence of any inquiry or request to do so, and that negligence of directors and their agents was no excuse.

In the cases referred to by counsel the officer of a bank was giving information in response to questions submitted to him and the statements made were a part of the duties which he was performing and within the scope of his powers and duties. The cases holding to the contrary are cases like our case where a general certificate was given by some officer not connected with any duties which he was performing for the bank, not within the scope of any of his powers or authority. This distinction is pointed out in the Willoghby case and is particularly noted in *Fidelity & Deposit Co. vs. Courtney*, 22 Sup. Ct. Rep. 833.

We wish to call the court's attention particularly to this latter decision as there are several points which bear upon the argument which we are now presenting. Quoting:

"Instruction No. 7 dealt with the \$2000.00 note transaction. In effect the jury were instructed that the knowledge of the cashier acquired in the performance of his duties might be imputed to the bank, but that the vice-president or an individual director did not hold such an official relation to the bank as that his knowledge of wrong doing by McKnight, if not communicated to the bank, could be treated as the knowledge of the bank. We do not deem it necessary to analyze the instructions given by the court for the purpose of determining whether they were in all respect accurate, because we are of the opinion that if the court in anywise erred it was in giving instructions which were more favorable to the defendant sureties than was justified by the prin-

ciples of law applicable to the case. It is well settled that in the absence express agreement the surety on the bond given to a corporation conditioned for the faithful performance of an employee of his duties is not relieved from liability for a loss within the condition of the bond by reason of the laches or neglect of the board of directors, not amounting to fraud or bad faith, and that the acts of ordinary agents or employees of the indemnified corporation conniving at or cooperating with the wrongful act of the bonded employee will not be imputed to the corporation."

And quoting further from this decision:

"Manifestly this stipulation is not fairly subject to the construction that it was the intention that the neglect or omission of a minority in number of the board of directors or the neglect or omission of subordinate officers or agents of the banks should be treated as the neglect or omission of the bank. The provision is not that a minority in number of the board of directors or that subordinate officers or agents would exercise due and customary supervision, and would not condone a default of the bonded employee or retain him in his employment after the commission of a default, but the agreement is that the bank would do or not do these things. This in reason imports that the things forbidden to be done or agreed to be done were better either done or left undone by the bank in its corporate capacity, speaking and acting through the representative agents and empowered by the charter to do or not to do the things pointed out. To hold to the contrary would imply that the bond forbade the doing of

an act by a person who had not power to perform or command a performance by one who could not perform. Assuredly, therefore, the conditions imputed in the stipulation to which we have referred, both as to doing and non-doing, contemplated in the reason of things the execution of the duties which the contract imposed on the bank, either by the governing body of the bank, its board of directors, or by a superior officer, such as the president of the bank, having general powers of supervision over business of the corporation, and vested authority to condone the wrong doing or to discharge a faithless employee. That is to say, the stipulation in all its aspects undoubtedly related to the bank acting through its board of directors, or through an official who from the nature of his duties, was in effect the vice-principal of the bank."

There was no evidence offered that the president had any of the powers mentioned in this decision. The evidence that was given upon the subject was to the contrary. Everything indicates that he was in no manner a vice-principal of the bank; he had no authority to condone the wrong or to discharge the faithless employee. He exercised no general power of supervision over the business of the bank. He was merely a nominal head possessing none of the powers necessary to bind the bank in the particulars set forth in this decision.

This decision further distinguishes this case from the case of *Guarantee Company of N. A. vs. Mechanics' Savings B. & T. Co.*, 183 U. S. 402; 22 Sup. Ct.

Rep. 124, for in that case the information was held imputable to the bank, for it had been communicated to the president of the bank and was required to be made by him.

We would call the court's attention to the case of *U. S. Fidelity & Guaranty Co. vs. Muir*, 115 Fed. 264; 53 C. C. A. 56 (Certiorari denied in 187 U. S. 648). This case quotes from the Pauly case and notes the distinction between the Pauly case and the case of Mechanics' Savings Bank, cited by counsel.

The court will notice in the Pauly case this thought, that the bond furnished in these cases was furnished by the cashier; the bank was not procuring the bond; it was a contract entered into originally between Stewart and the bonding company. It is true it was for the benefit of the bank and later it became a statutory bond required by the statute. Assuming for the purpose of this argument, however, that it was a contract bond, the contract was made between Stewart and the company and not between the company and the bank, as was said in the Pauly case:

"In the first place the procuring of a bond for O'Brien, in order that he might become qualified to act as cashier, was no part of the business of the bank, nor within the scope of any duty imposed upon Collins as president of the bank. It was the business of O'Brien to obtain and present an acceptable bond."

It is our contention that provisions contained in the bond imposing certain conditions upon the bank

and making the representations of one officer of the bank binding upon the bank would be without authority, for the company could not say who should represent the bank; the law directs where authority shall be vested in the management of the affairs of a bank, with the additional right to impose authority upon other officers and employees.

Counsel in their brief under this head have cited a great many decisions and a number from the Supreme Court of Washington. We confidently believe that when the court comes to examine these authorities it will readily be seen that they have no application to this question.

All of this argument under this branch of the case is pertinent only upon the theory that the bond sued upon in this case was not a statutory bond but a common law bond. If it is a statutory bond, as we contend it is, then this argument becomes irrelevant and immaterial.

NO DISHONESTY

Under this title counsel argue that there was no dishonesty shown. The bond in force until April 30, 1920, was conditioned to reimburse the bank for all loss which the bank sustained "by any dishonest act or acts" of the said Stewart in the performance of the duties of his office or employment. The bond given and in force from April 30, 1920, until the bank failed was conditioned to cover loss through fraud, dishon-

esty, forgery, theft, embezzlement or wrongful abstraction.

We have already called the court's attention to the fact that the loan to Stewart under the trade name of the Kelso Farm Company for \$5950.00, the Fritz Kruse accommodation note for \$5000.00, and the Fisk dummy note for \$5000.00 were all under the bond given on April 30, 1920, but aside from that question, if Stewart took the bank's money illegally or unlawfully or with a fraudulent or dishonest purpose, it would render the company liable under the conditions of the first bond, for if he was guilty of a crime under the law and took the money in violation of law, it would be a dishonest act.

The evident purpose of the bond was to cover the unlawful appropriation of the funds of the bank, what other purpose could the bond serve? If it was only intended to cover immoral acts where the bank suffered no loss what was the reason for giving it? It was clearly intended to cover just such losses as the bank suffered here, losses occurring through the fraudulent, unlawful and criminal acts of the officers of the bank.

It has been our understanding that when an act is made a felony, a serious crime, that to violate the law is both immoral and illegal, and dishonest in the meaning of dishonesty as used in this policy; but counsel say that it was merely an exercise of poor judgment and urge that Stewart did no intentional wrong; that

is far from the facts, there is no question of judgment. Stewart took the money illegally and used it. Under counsels' contention if an employee of a bank takes the money of the bank with the sincere intention of repaying it, it is not dishonest, but it is, nevertheless, a crime, and it would be dishonest regardless of his good intentions. If Stewart had taken this money from the bank without any semblance of a loan, with the intention of paying it back, and had used it in his private enterprises, would counsel contend that the act was not dishonest and within the purview of the policy? What is the difference here? The only difference is that he gives his note, or the note of some friend who was interested with him in some private deal, and takes the money. He does not take it clandestinely, there is a record of it, but he takes it just the same, and the bank loses it. The legal liability is the same, the moral and criminal responsibility are the same. In both cases it is illegal and dishonest and made a crime.

We would call the court's attention to *State vs. Lindberg*, reported in Vol. 25, Washington Decisions, No. 1, p. 128.

In this case the defendant was prosecuted under the banking laws of the State of Washington. The defendant was a stockholder and a director in the bank and while such director borrowed from the bank on his unsecured note the sum of \$13,000.00. The bank subsequently became insolvent and was taken in charge by the state banking officers for liquidation.

The information charged that the defendant while a director of the bank named borrowed the money therefrom without a resolution authorizing the same and approved by a majority of the directors of the bank at a meeting at which he was not present, and entered in the corporate minutes of the bank. The defendant was found guilty and the conviction was sustained by the Supreme Court. Referring to the contentions of counsel and to the statute the court said:

“Clearly, to our minds, this is a provision directed against the borrowing officer, and makes him guilty of a felony if the borrowing is in violation of the provisions of the act.”

Again:

“Nor was it necessary that the state allege and prove a financial loss as a result of the borrowing. By the terms of the statute, the crime is complete when the borrowing is consummated without a compliance with the statutory requirements; loss of the money borrowed is not an element of the offense.”

The charge against the defendant in this case was the borrowing of money from the bank while an officer of the bank and the court sustained a conviction without other showing of wrongful intention or a criminal intent. So if the defendant in that case was guilty of a crime, Stewart was guilty of a crime when he took the money belonging to the Kelso State Bank whether he took it directly or indirectly through the discount of his own worthless notes to the bank.

In *State vs. Larson*, reported in Vol. 22, Washington Decisions, No. 10, p. 471, the Supreme Court of Washington had occasion to pass upon the withdrawal of money from a bank by the vice-president and manager. In that case the vice-president was also interested in another bank which was in financial distress. It was a member of the Federeal Reserve Bank and the Federal Reserve officers were threatening to cancel the membership. In order to avoid that an agreement was made to raise a certain amount of money; to do that the defendant drew from the bank of which he was vice-president a sum of money and deposited it to the credit of the other bank; the defendant was charged with embezzlement and the Supreme Court sustained a verdict of guilty. In passing upon the matter the court said:

“The mere fact that an officer of the bank makes a loan from that institution, however regular and usual it may, on its face, appear to be, does not necessarily deny intent upon his part to defraud the bank by converting the money to his own use. * * * Being in a position of trust and thus having possession of the bank’s money he may be guilty of larceny provided he takes the money feloniously and with the purpose and intent to defraud the bank and for his own use. The mere fact that the transaction may take the form of a loan would not necessarily deprive it of its criminality.”

The Supreme Court of Washington quotes from *Reeves vs. State*, 95 Ala. 31; 11 South. 158. It was held in that case that,

“Such an officer may be convicted of embezzlement or fraud in converting to his own use money belonging to the bank, although he possesses control thereof, and that it was immaterial whether his acts were perpetrated secretly or openly; and that, if such acts were consummated under the guise of a bona fide loan made with the assent of the other officers of the bank, such would not eliminate the criminality of the act, and that the fraud itself might be inferred from the misappropriation of the funds.”

Quoting further from the Wash. decision:

“The distinction is between the making of mere irregular, unsafe or reckless loans of the bank’s money, which would amount to maladministration only, and pretended loans, made in bad faith for personal advantage and with fraudulent intent, the pretended borrower being an officer, agent, clerk or servant having control and custody of money of the bank by virtue of his office or employment, which control and custody is shared by those making the pretended fraudulent loan, and who participate in the fraudulent purpose of the pretended borrower.”

The case of *State vs. Kortgaard*, 62 Minn. 7; 64 N. W. 51, is very much in point on this question. It was held in that case that if a bank officer appropriated to his own use the funds of the bank entrusted to his custody with intent to deprive the bank of its property it is none the less embezzlement because done under the guise or form of a loan to himself, or an overdraft of his account.

Quoting further from the *Larson* case:

“Under our statute the offense is committed when the taking is felonious, and it is immaterial whether the taker has in mind that he will return the property taken or that he is taking it only for his own use temporarily.”

In this case Stewart discounted the Phillips, Shepard and Northwest Transportation Company notes to the bank and took credit for the sums represented by the notes. He had procured these notes through private deals and private transactions in which he was directly interested. He received the bank's money by the manipulation of these notes. Under the *Larson* case, *supra*, he was guilty of embezzling the funds of the bank. It was immoral, dishonest and criminal. The Kruse accommodation note, the Fisk dummy note, the Kelso Farm loans, was money taken directly by Stewart from the bank and he was guilty of violating the provisions of the banking act and also of embezzlement under the holding of the court in the *Larson* case. The same may be said of the Richter warrants. These warrants belonged to an estate, he put them in the bank and drew the money and used it for his private purposes. He was guilty of a double crime here, he was attempting to defraud the guardianship estate and violating the banking laws and the embezzlement statute of the state.

NO LOSS

It is contended by counsel that the record does not disclose that the bank sustained any loss.

The evidence establishes beyond any question that in the matters and items discussed and upon which the court based its findings that Stewart took credit in his own personal account for the sums of money represented by the various notes and other transactions mentioned. That, of itself, constituted a crime and was an appropriation of the bank's funds. It is not material, as far as the bank is concerned, what Stewart did with the money. When he took credit, drew the money from the bank and placed it in his personal private account, the bank lost the money; it was taken from the bank's assets and became subject to the control and disposition of Stewart. He could have been prosecuted under the laws of Washington, even though he did not make further disposition of the funds. When he drew the money on the Phillips notes, and the Shepard notes and the Northwest Transportation Company notes, and took credit for them on his own account the funds of the bank to that amount were transferred to his account and became subject to his control and disposition. When he drew from the bank the \$5000.00 represented by the Fisk dummy note he took from the funds of the bank that amount of money, and the same was true when he drew from the bank the \$5000.00 represented by the Fritz Kruse note and the Kelso Farm Loan notes and the Richter warrants. Furthermore, if it was necessary to establish that Stewart had disbursed those funds, which we do not concede, the evidence of Judge McKenney (pp. 346-347 of the transcript), shows that at the time

the bank failed and Stewart disappeared that his indebtedness amounted to about \$200,000.00, and outside of some property covered by mortgages his estate did not exceed \$1500.00, so that he was substantially \$200,000.00 worse off than nothing, and how can it be argued by counsel that the bank lost nothing when the money was taken by Stewart, used by him, and was taken from the bank and never returned?

VARIANCE

Counsel complain of a variance between the pleadings and the proof. There is no showing that counsel was surprised or in any manner prejudiced by any possible variance between the pleadings and the proof. Under the bonds furnished by the plaintiff in error counsel was given full opportunity to make investigation of the affairs of the bank before any action was commenced. Counsel embraced that opportunity, made an exhaustive examination in great detail, of the affairs of the bank, and were thoroughly familiar with every item of loss claimed by the liquidating officer. They entered into a stipulation with reference to the Richter warrants; they were thoroughly familiar with the Phillips, Shepard and Northwest Transportation Company notes from the time they came into the bank and with all of the matters with which the notes were in any manner connected. They had all of this information before the action was commenced and the record will disclose that from time to time during the trial they made suggestions and

gave information about the notes showing their thorough and entire familiarity with all matters connected with the notes.

In view of these facts and the further fact that no prejudice or injury has been shown, or even claimed during the trial, the plaintiff in error is not now in a position to urge any error because of any possible variance.

We therefore submit that the judgment of the lower court should be affirmed.

Respectfully submitted,

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